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Maurice P. Talbot, Jr.
Executive Director-Federal Regulatory

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July 30, 1996

Ex Parte

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Mr. William F. Caton
Acting Secretary
Room 222
1919 M Street, N.W.
Washington, D.C. 20554

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Re: Written Ex Parte, CC Docket No. 96-112, Allocation of Costs
Associated with LEC Provision of Video Programming Services

Dear Mr. Caton:

BellSouth hereby submits for the record this letter and the attached study by Theodore Barry & Associates ("TB&A").

In previous submissions, BellSouth has cautioned the Commission that an exogenous price cap adjustment based on the arbitrary 50/50 allocation of common costs proposed in the Notice would penalize telephone companies for deploying broadband networks and entering video programming markets in competition with incumbent cable operators and that such a penalty would discourage broadband infrastructure investment and competitive entry. Such disincentives would be contrary to the goals of the Telecommunications Act of 1996 to encourage infrastructure development and telephone company entry into the video programming business.¹

Adoption of the Notice's proposal or the even more punitive proposals of the cable industry would cause a reallocation of substantial investment in existing plant even though (1) that plant has been placed to meet current or projected demand for telephone services, (2) little of that plant is available for use in the provision of video services, and (3) use of available spare capacity in that plant for the provision of video services would require advancement of

¹ See Telecommunications Act of 1996 Conference Report, H. R. Rep. 104-458 at 172-173 (Jan. 31, 1996). The 1996 Act manifests a specific congressional intent to "hasten the development of video competition" and "provide consumers with increased program choice" through eliminating obstacles to competitive entry by telephone companies.

capacity additions to serve the projected telephone demand for which such spare is now held.² Exogenous price cap adjustments based on such reallocations would constitute a penalty on the investment and entry into new markets by local exchange carriers (LECs).

The attached TB&A study quantifies the relative financial impact of cost allocation methods proposed in this proceeding. It includes analysis of the Notice's 50/50 proposal, the Florida PSC's proposal based on homes passed with video facilities, and the method currently in effect in BellSouth's Cost Allocation Manual "CAM"), which is based on the number of video subscribers. The video forecast data underlying this study (TB&A at 7) is based on the forecast used in BellSouth's current cost allocations under its CAM. The potential impact of resulting investment reallocation and associated exogenous adjustments is significant.

The significance of such exogenous adjustments is most apparent when the results of the TB&A study are applied to BellSouth's video business case and expressed in terms of their effect on the internal rate of return ("IRR") in that business case. The following chart shows the IRR effect of the stated cost allocation approaches:

Allocation Methodology	% Change in IRR
FCC: Study Area	-132%
FCC: Wire Center	-29%
Homes Passed Wire Center	-19%
Subscribers: Wire Center	-4%

From this analysis, it is obvious that reductions in telephone rates by an exogenous price cap adjustment associated with any of these methodologies would impair BellSouth's business case for investment in broadband facilities and competitive entry into the provision of video programming services. Of course, the larger the downward adjustment in the price cap index, the larger will be the reduction in the IRR of BellSouth's video business case. Even relatively small impacts on IRR are not, however, insignificant. Within firms like BellSouth, managers advocating investment in facilities for the video business compete for capital funds with managers advocating other investment opportunities such as wireless or international ventures. The scarcity of investment capital and the pressures of capital markets demand that the firm choose among investment

² See Declaration of Dan L. King, attached to letter to William F. Caton from Maurice P. Talbot, Jr., filed July 19, 1996.

broadband facilities for video entry less competitive relative to other opportunities.

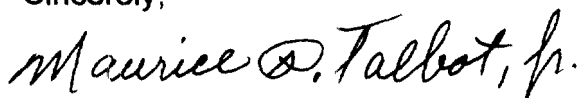
This proceeding is a test of the Commission's resolve to promote investment in broadband infrastructure and competitive entry into video markets by telephone companies, as Congress intended when it enacted the Telecommunications Act of 1996. The Commission already has in place a regulatory model (*i.e.*, price caps) that makes cost allocations unnecessary as a safeguard against cross-subsidy and that enables the market to operate without the distortions inherent in rate-of-return regulation. Adoption of exogenous price caps adjustments based on proposed cost allocation methodologies would bestow a windfall on telephone ratepayers without improving safeguards against cross-subsidy. It would constitute a lapse into rate-of-return regulation and a retreat from the objectives of price cap regulation.

Moreover, even if the Commission feels it necessary to continue with cost allocations, the current cost allocation rules already in Part 64 of the Commission's rules provide a sufficient safeguard against cross-subsidy. No new cost allocation rules are necessary. Most especially, the Commission should not adopt those proposed in the Notice which contain an arbitrary 50-50 cost allocation and an exogenous adjustment factor that provides a penalty to LECs investing in a joint-use wireline broadband facility to provide video programming services.

No such penalty will be imposed on cable operators that use their cable facilities to enter the telephone business. Such uneven regulation of competitors will only retard the development of competition and infrastructure development and deprive consumers of the benefits of fully competitive markets.

Pursuant to Section 1.1206(a)(1) of the Commission's Rules governing written ex parte presentations, two copies of this letter and the TB & A study: "Analysis of Cost Allocation Methodology" are attached for inclusion in the public record in the above-captioned proceeding. Copies of this letter and the TB & A Study are also being provided to FCC staff on the attached Distribution List.

Sincerely,

A handwritten signature in cursive script that reads "Maurice P. Talbot, Jr.".

Maurice P. Talbot, Jr.
Executive Director-Federal Regulatory

Attachment

CC: See attached Distribution List

Distribution List
for
Theodore Barry & Associates Study:
Analysis of Cost Allocation Methodology
CC Docket No. 96-112
July 30, 1996

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FCC CC No. 96-112: Analysis of Cost Allocation Methodology

July 1996

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Introduction

- ◆ Theodore Barry & Associates (TB&A) was requested to perform an assessment of the overall implications of the FCC's May 10, 1996, Notice of Proposed Rulemaking in CC Docket No. 96-112, Allocation of Costs Associated With Local Exchange Carrier Provision of Video Programming Services:
 - Development of a thorough understanding of the objectives of the NPRM
 - Analysis of the primary and secondary impacts of the implementation of the NPRM
 - Identification and assessment of alternatives to the NPRM

Introduction (continued)

- ◆ TB&A's analysis and conclusions are organized in this report as follows:
 - **Introduction**, this section
 - **Perspective**, which places CC Docket No. 96-112 in the context of the FCC's overriding objectives
 - **Objective and Approach**, which describes TB&A's focus and analytic approach used in assessing the NPRM
 - **Conclusions and Recommendations**, which concludes as to the impact of and consequent appropriateness of the NPRM's implementation based on the foregoing analysis and, further, recommends an appropriate action to best accomplish the FCC's overarching goals
 - **Appendices**, which include relevant data and analyses

Perspective

- ◆ The proposed rules relating to the allocation of common costs and expenses associated with a local exchange carrier's provision of video programming services should be assessed in light of the FCC's ultimate objectives:
 - The promotion of competition in telephony and other communications services (such as video services)
 - The encouragement of investment in related new technologies and infrastructure
 - The maximization of consumer choice in information and entertainment services
- ◆ Cost allocations have the potential to have a significant impact on the accomplishment of these goals
 - Cost allocations can affect a company's cash flow, which is the primary basis on which its investment decisions are made
 - Cash flow is the basis for investment decisions because the economic value of the firm is the discounted value of expected cash flows while a company's stock price is the present value of such cash flows after payment of interest expenses
 - Discretionary investments which do not yield cash flow above the cost of capital cannot be prudently made by management because they would diminish the value of the firm, and investments which offer the greatest discounted cash flow typically receive the highest priority in funding
 - Reduced investment by telephone companies in video services will likely mean reduced competition and reduced customer choice in that market

Project Objective and Approach

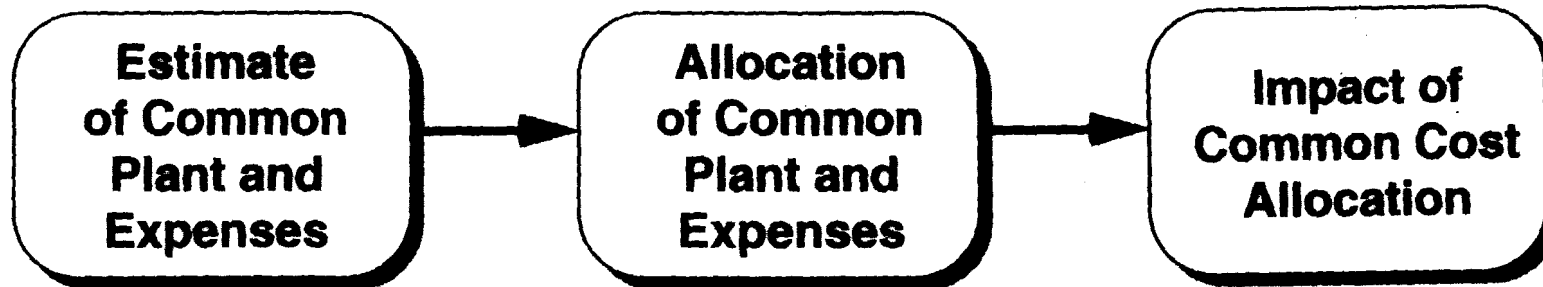
Objective

- ◆ TB&A's objective was to assess the impact that various cost allocation methodologies may have on a representative RBOC and the related implications for the FCC's objectives of competition in video services and investment in new technologies
- ◆ Reflecting the critical link between cash flow and investment, TB&A's analysis of CC Docket No. 96-112 was made in terms of the likely impact that the NPRM will have on revenue requirements and shareholder value

Project Objective and Approach

Approach

- ◆ TB&A's approach to identifying the impact of common cost allocation on LEC video services operations and the related impact on cash flow comprised three steps



- ◆ For this analysis, TB&A modeled the impact of cost allocation methodologies assuming
 - A representative RBOC serving its incumbent service area with selected common communications plant
 - A business structure under which a regulated telecommunications provider sells transport to an unregulated subsidiary providing programming and marketing
 - A video services operation with one operational trial, having made about \$15 million in dedicated investment at present

Estimate of Common Plant and Expenses

Approach

- ◆ TB&A modeled a "typical" one-state telephony/video services operation assuming:
 - Total gross study area investment of \$7.8 billion with operating expenses totaling \$1.7 billion
 - About 4.0 million equivalent DS0 access lines in the study area
 - ATM switching dedicated to video services
 - Hybrid copper/coaxial cable (dedicated investment) initially deployed in the last mile of the loop, eventually migrating to switched digital video (SDV) technology
- ◆ The operations forecast incorporates the following rollout plan:
 - 218,000 homes passed in three years
 - 17,450 subscribers in three years, or about an 8% penetration level
 - 15 video-capable wire centers of a total 178 study-area wide in five years, with 413,745 access lines

Estimate of Common Plant and Expenses

Finding

- ◆ About 43% of the study areas' gross investment is used in common for telephony and video service, where types of plant are assigned in the following fashion

	Common	Dedicated Telephony	Dedicated Video
Loop Plant	<ul style="list-style-type: none">• Fiber in the loop• Loop electronics	<ul style="list-style-type: none">• Copper twisted pair• Narrowband loop electronics	<ul style="list-style-type: none">• Last Mile copper/coaxial cable• Loop electronics
Switching Plant	<ul style="list-style-type: none">• Central office support investment - racks, ladders, frames, etc.	<ul style="list-style-type: none">• Narrowband switching	<ul style="list-style-type: none">• ATM switch
Interoffice Facilities	<ul style="list-style-type: none">• Fiber facilities where video deployed in study area	<ul style="list-style-type: none">• None	<ul style="list-style-type: none">• None
Poles, Conduit	<ul style="list-style-type: none">• All poles, conduit, pole attachments	<ul style="list-style-type: none">• None	<ul style="list-style-type: none">• None
General Support Assets	<ul style="list-style-type: none">• All land, buildings, office equipment, general purpose computers, etc.	<ul style="list-style-type: none">• Corporate communications equipment	<ul style="list-style-type: none">• None

Estimate of Common Plant and Expenses

Finding (continued)

- ◆ About 56% of the study area's operating expenses relate to activities common to both telephony and video services, with expenses assigned as follows

	Common	Dedicated Telephony	Dedicated Video
Maintenance Expense	<ul style="list-style-type: none">• Maintenance on all common plant plus general support assets	<ul style="list-style-type: none">• Maintenance on dedicated regulated plant	<ul style="list-style-type: none">• Maintenance on dedicated video plant
Other Network-Related Expense	<ul style="list-style-type: none">• Plant ops and admin and engineering personnel common to tel and video	<ul style="list-style-type: none">• Plant ops, admin and engineering personnel dedicated to telephony	<ul style="list-style-type: none">• Plant ops, admin and engineering personnel dedicated to video
Marketing	<ul style="list-style-type: none">• Common general advertising, general sales, and other misc. marketing	<ul style="list-style-type: none">• Dedicated advertising, product management, sales and customer service costs	<ul style="list-style-type: none">• Product management employees dedicated to video services
Overheads	<ul style="list-style-type: none">• Executive, planning, accounting and finance, external relations, MIS, legal, and other corporate activities	<ul style="list-style-type: none">• Minimal	<ul style="list-style-type: none">• None

Estimate of Common Plant and Expenses

Finding (continued)

- ◆ As modeled, study area common cost pools which would be affected by video services total \$3.3 billion in gross plant and about \$1 billion in expenses, in contrast to current dedicated video services costs of \$16 million in investment and \$7 million in expenses

Assets (\$ million)1996	Common	Dedicated	Expenses (\$ million)1996	Common	Dedicated
Loop	\$1,379.8	\$15.2	Maintenance	\$148.7	\$0.4
Switching	74.1	1.1	Other Network	111.0	5.5
Interoffice Facilities	752.7	-	Deprec. and Amort.	467.1	-
General Support Assets	1,134.4	-	Marketing	27.1	.8
TOTAL	\$3,341.0	\$16.3	Overheads	190.8	-
			TOTAL	\$944.7	\$6.7

Allocation of Common Plant and Expenses

Approach

- ◆ The common plant allocated to nonregulated services such as video and to regulated telephony is determined by two factors:
 - The "basis" of allocation
 - The level of tracking of the investment and expenses to be allocated and the level of allocation basis
- ◆ For this analysis, TB&A compared the FCC's proposed 50:50 "fixed factor" allocation with two alternatives:
 - *Homes Passed* methodology reflects the comments filed by the Florida Public Service Commission suggesting that the allocation basis be proportionate to the projected number of potential subscribers to video services out three years
 - *Subscribers* allocation methodology, currently being applied by BellSouth, allocates plant based on a three year projection of actual subscribers to the service relative to the sum of total DSO equivalents and video subscribers
- ◆ The level of tracking was considered at the:
 - Study Area Level, which has the benefit of simplicity of tracking and application
 - Wire Center Level, which offers greater accuracy. For the purposes of this analysis, wire center investment was approximated from study area level numbers based on the number of DSO equivalent access lines in video-capable wire centers

Allocation of Common Plant and Expenses

Approach (continued)

- ◆ While assets were allocated along the methodologies described previously, Part 64 rules were applied to expenses in all scenarios

	FCC	Homes Passed	Subscribers
Loop Plant	50/50 Fixed factor	Homes Passed	Subscribers
Switching Plant	50/50 Fixed factor	Homes Passed	Subscribers
Inter-Office Facilities	50/50 Fixed factor	Homes Passed	Subscribers
General Support Assets	Modeled based on allocation of direct assets		
Network Related Exp. (including Maintenance)	Proportional to allocation of facilities		
Marketing Expense	Part 64		
Overheads	Part 64		

Allocation of Common Plant and Expenses

Finding

- ◆ Gross investment allocations to video services at the *study area* level range from \$1.2 billion (\$569 million net) under the FCC proposal approach to \$24 million (\$12 million net) under a subscriber-based approach. Applied at the *wire center* level, investment allocations range from \$136 million gross (\$65 million net) to \$23 million (\$11 million net)

Approach	Allocation Level	Investment (\$MM)		Expenses (\$MM)
		Gross	Net	
FCC	Study Area	\$1,192.0	\$569.4	\$292.0
	Wire Center	135.9	65.0	38.1
Homes Passed	Study Area	138.2	66.1	38.7
	Wire Center	97.9	46.9	28.1
Subscribers	Study Area	23.8	11.5	6.0
	Wire Center	23.2	11.2	5.9

Impact of Common Cost Allocation

Approach

- ◆ The allocation methodologies were assessed based on their impact on the "average" RBOC's revenue requirement and cash flow, the equivalent video service market share, and the associated impact on an average RBOC's shareholder value
- ◆ Cash flow impacts were found to be linked primarily to exogenous treatment under federal and state price caps, with some potential impact on current and proposed universal service funding
- ◆ To focus on the most significant impact, all three allocation methodologies were assessed solely on the price cap exogenous treatment cash flow impact and, ultimately, the related implications for the congruency of the cost allocation methodologies with Congressional and FCC objectives

Impact of Common Cost Allocation

Approach: Revenue Requirements

- ◆ The following key assumptions were used to determine the cash flow impact resulting from exogenous treatment under federal and state price caps
 - 11.25% allowed return basis for both interstate and intrastate revenue requirements calculations
 - Applied against 1996 interstate and intrastate common investment and expenses
 - Price cap adjustment (revenue requirements reduction) assumed to equal annual pre-tax cash flow reduction
 - Related reduction in value of the average RBOC assumes five years of reduced cash flow, a 40% marginal income tax rate, and an 11.25% weighted average cost of capital
 - An average RBOC is assumed to have seven study areas and to be subject to price caps regionwide at both state and federal levels

Impact of Common Cost Allocation

Finding:

Annual Revenue Requirement Impact

- ◆ Depending on the allocation methodology chosen, assuming exogenous treatment at federal and state levels, an RBOC deploying video service in seven states could see a reduction in revenue requirements ranging from \$55 million to \$2.7 billion

Approach	Allocation Level	\$MM/Annually			
		Interstate	Intrastate	Total Per State	Average RBOC
FCC	Study Area	\$97.9	\$293.7	\$391.6	\$2,741.2
	Wire Center	12.4	37.1	49.5	346.5
Homes Passed	Study Area	12.6	37.7	50.3	352.1
	Wire Center	9.1	27.2	36.3	254.1
Subscribers	Study Area	2.0	6.0	8.0	56.0
	Wire Center	2.0	5.9	7.9	55.3

Impact of Common Cost Allocation

Finding:

Cable Market Penetration

- ◆ Given the state forecast modeled for this analysis, at a minimum the LEC would need to more than double its projected market share (without additional expenditures) to make up the revenues lost with exogenous treatment
- ◆ Under 50:50 fixed factor application at the study area level, recovery through incremental market share in the planned service territory would not be feasible

Allocation Methodology		Subscribers (000)	Market Share (Perc. Points)
FCC	Study Area	1,001.5	Over 100
	Wire Center	125.6	58.1
Homes Passed	Study Area	128.6	59.0
	Wire Center	92.8	42.6
Subscribers	Study Area	20.5	9.4
	Wire Center	20.2	9.3

LEC Forecast	17.5	8%
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Assumes NCTA 1995 average revenue per subscriber of \$391/year

Impact of Common Cost Allocation

Finding:

Revenue Requirement Impact On Shareholder Value

- ◆ The cost allocation methodology can have a considerable impact on an RBOC's cash flow and shareholder value
 - Low end impact: Under a usage-based cost allocation scenario applied at the study area level, the potential decline in shareholder value is projected to be about \$122 million
 - FCC proposed (study area) scenario impact results in a decline in shareholder value of about \$6.0 billion

Approach	Allocation Level	Interstate + Intrastate Rev. Req.'s NPV (\$MM)	
		Per State	Avg. RBOC
FCC	Study Area	\$862.9	\$6,040.3
	Wire Center	109.1	763.7
Homes Passed	Study Area	110.7	774.9
	Wire Center	80.1	560.7
Subscribers	Study Area	17.7	123.9
	Wire Center	17.4	121.8

Conclusion

- ◆ The impact of the selected cost allocation methodology on telephony services providers can be so significant as to deter any investment in video services provision
 - Fiduciary responsibilities require RBOC management to assess various investments in terms of their total impact on cash flow
 - Even cost allocation methodologies with a more limited impact on cash flow and shareholder value could cause LEC management to reconsider entry into a market which offers such immediate downside
- ◆ A fixed factor (50:50) applied to investment and expenses at the study area level generates a large reduction in shareholder value because it allocates LEC investment supporting a large geographic area
 - Such an approach effectively ignores the extent to which the network is even capable of being used to deliver video services
 - Under all methodologies, wire center level allocation better isolates the common investment and expenses which are likely to be impacted by video service provision

Recommendations

- ◆ Recognizing the potentially devastating impact that cost allocation methodology may have on the achievement of Congressional and FCC objectives, the FCC should treat changes in common cost allocation as a non-exogenous event for price cap purposes
- ◆ In the interest of achieving its and Congress' objectives of increased investment and consumer choice, the FCC should adopt a cost allocation methodology which minimizes the potential impact on LEC cash flow, since FCC cost allocation methodologies may have impacts beyond those related to exogenous treatment for FCC price cap purposes:
 - Cost allocation methodologies may affect universal service funding
 - FCC cost allocation methodologies, by serving as the basis for many state cost allocations, can affect cash flow at the state level, and possibly deter investment in a particular state and, in aggregate, nationwide
- ◆ Whatever cost allocation methodology the FCC selects, the FCC should permit cost allocation at the wire center level or lower if practicable. The wire center or lower level of detail may add little if any to administrative burden and should better capture the relevant economics of the business venture

Appendix

FCC Approach Allocations

- ◆ The proposed FCC allocation basis would yield an allocation of \$1.2 billion in common plant (\$292 million in expenses) if applied to the study area level, and \$136 million in investment (\$38 million in expense) if applied to the wire center level

Assets (\$ million) 1996	Common	Dedicated	Expenses (\$ million) 1996	Common	Dedicated
Study Area Level			Study Area Level		
Loop	\$ 689.9	\$15.2	Maintenance	\$53.1	\$.4
Switching	37.0	1.1	Other Network	55.5	5.5
Interoffice Facilities	376.4	-	Deprec. and Amort.	167.0	-
General Support Assets	88.7	-	Marketing	1.2	0.8
TOTAL	\$1,192.0	\$16.3	Overheads	15.3	-
			TOTAL	\$292.1	\$6.7
Wire Center Level			Wire Center Level		
Loop	\$71.8	\$15.2	Maintenance	\$ 6.1	\$.4
Switching	3.9	1.1	Other Network	5.8	5.5
Interoffice Facilities	39.2	-	Deprec. and Amort.	19.0	-
General Support Assets	21.1	-	Marketing	1.2	0.8
TOTAL	\$136.0	\$16.3	Overheads	6.1	-
			TOTAL	\$38.2	\$6.7